Prudential supervision of banks in the South African context – the supervisory review and evaluation process

Nico De Lange and Madoda Petros

Executive summary

The purpose of prudential supervision of banks in South Africa is to ensure the safety and soundness of the South African banking system and to contribute to the stability of the financial sector.

The Bank Supervision Department (BSD) of the South African Reserve Bank is the body responsible for prudential supervision of banks. The Banks Act, 1990 (Act no 94 of 1990 – “the Act”) provides these powers to the BSD.

Section 4(4) of the Act states that the Registrar shall implement a supervisory review process.

With the advent of the Basel II Framework, the BSD updated its supervisory review process, now formally known as the Supervisory Review and Evaluation Process (SREP).

The SREP serves as the conduit for streamlining prudential supervision of banks in South Africa and the cycle consists of six stages.

Risk-based supervisory practices are embedded in each stage of the SREP.

We believe that the SREP will ensure appropriate corrective actions, given that it considers individual bank and systemic conditions, resulting in a safe and sound banking system.

1. Background

1.1 Responsibility for prudential supervision in South Africa

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1.2 Mission of the Bank Supervision Department of the South African Reserve Bank

The mission of the BSD is to promote the soundness of the banking system through the effective and efficient application of international regulatory and supervisory standards.

The body that sets global banking regulatory and supervisory standards is the Basel Committee on Banking Supervision (BCBS). The BCBS Secretariat is located at the Bank for International Settlements (BIS) in Basel.

1.3 Brief history of Basel I and development of Basel II

The Basel Capital Accord (Basel I), published in 1988, was formulated by the BCBS. At the core of this international regulatory regime was a requirement that banks maintain a minimum capital adequacy ratio of 8 per cent based on their risk-weighted assets. This standardised approach was deemed appropriate then. Since 1988 the global landscape has changed. Events and innovations that have occurred include the following:

- Deregulation of financial markets
- Globalisation (global markets)
- Competitive pressures (margins)
- Improved technology (new products and delivery systems)
- Consolidation (mergers and acquisitions)
- Changing role of disintermediation (risk transfer)
- Risk management revolution

The above resulted in the Basel I framework becoming outdated.[1] In the late 1990s, the BCBS commenced the work that led to the formulation of the Basel II Framework. Basel II was published in June 2004.

Basel II consists of three Pillars.

- Pillar 1 sets out the minimum capital requirements that banks must meet in respect of credit, market and operational risk. The requirements with regard to Pillar 1 are largely rules-based.
- Pillar 2 prescribes the requirements for "supervisory review". Banks must assess their capital adequacy relative to their overall risks. In addition, requirements are imposed on supervisors of those banks to review and take appropriate action in response to those assessments. The requirements with regard to Pillar 2 are largely principles-based.
- Pillar 3 describes the requirements for "market discipline". Banks must publish certain details of their risks, capital and risk management. The aim of this requirement is to strengthen market discipline through transparency and disclosure.

The end result is a more flexible and risk-sensitive framework that imposes more onerous requirements on both banks and supervisors.

The cornerstones of the new framework encapsulated under Pillar 2 are the specific requirements that banks should develop their own internal capital adequacy assessment process (ICAAP) and that supervisory authorities should review these assessments. The aim is to enhance the links between an institution's risk profile, risk management and capital.

[1] The weakness of Basel I was that it was standardised and blunt. The framework was not sufficiently risk-sensitive and represented a "one size fits all" approach. Important risk areas such as operational risk, liquidity risk, interest rate risk in the banking book and concentration risk were ignored.

In the light of the mission of the BSD (see 1.2 above), the answer to the question whether or not South Africa should adopt Basel II was self-evident. Implementation occurred on 1 January 2008.

In terms of the Banks Act, 1990 (Act no 94 of 1990) banks are obliged to maintain at all times overall financial resources which are adequate as to both amount and quality, in order to ensure that the risk of not meeting their liabilities as they fall due is insignificant.

The adequacy of a bank's capital needs to be assessed by both the bank and the BSD. Individual capital adequacy standards in terms of Basel II comprise:

- an ICAAP, which a bank is obliged to carry out; and
- a supervisory review and evaluation process (SREP), which is conducted by the BSD.

The remainder of this paper will focus on the SREP.

2. The SREP

As part of the Basel II implementation process, the BSD revisited its supervisory framework, and modifications were made to it, resulting in an updated supervisory framework known as the SREP.

2.1 Modification to the SREP

As a starting point, it was recognised that Basel II is more risk-sensitive than Basel I.

It was also recognised that risk management practices in banks have evolved considerably over the recent past.

Furthermore, it was incumbent upon the Department to adopt the four principles contained in Pillar 2 of Basel II in the SREP. The four principles under Pillar 2 can be categorised as follows:

Bank's responsibilities

- A bank should have in place a process for assessing its overall capital adequacy in relation to its risk profile and a strategy for maintaining its capital levels (Principle 1).
- A bank should operate above the minimum regulatory capital ratios (Principle 3).

The above is generally known as the ICAAP (Internal Capital Adequacy Assessment Process).

Supervisor's responsibilities

- A supervisor should review and evaluate a bank's ICAAP (Principle 2).
- A supervisor should take appropriate action if it is not satisfied with the results of this process (Principle 2).
- A supervisor should review and evaluate a bank's compliance with the regulatory capital ratios (Principle 2).
- A supervisor should have the ability to require banks to hold capital in excess of the minimum (Principle 3).

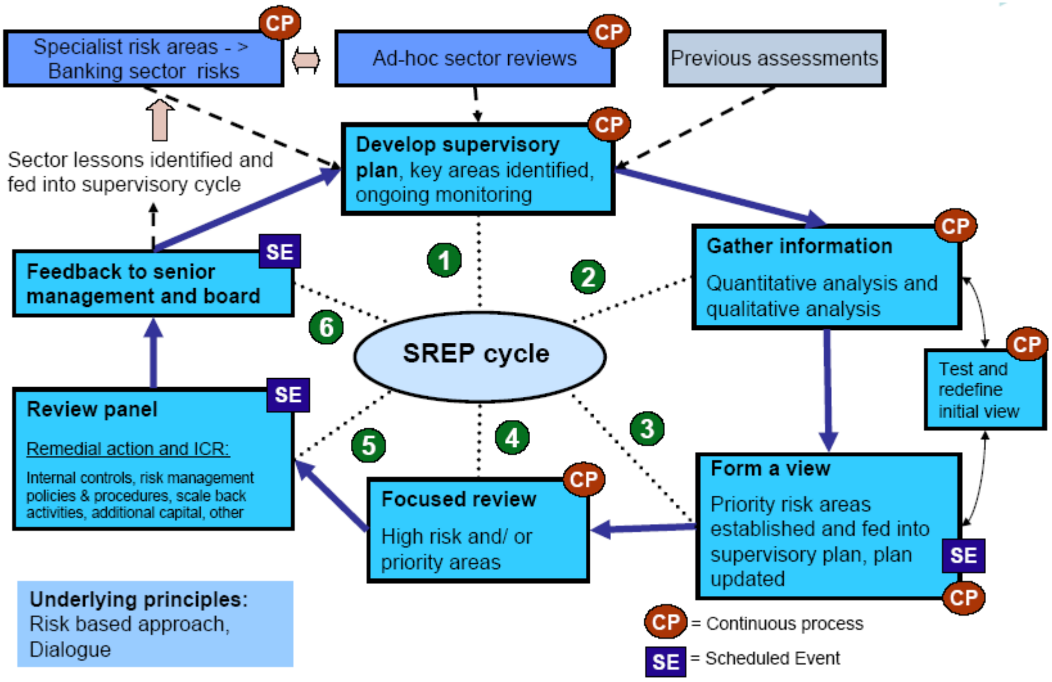
- A supervisor should seek to intervene at an early stage to prevent capital from falling below the minimum prescribed levels (Principle 4).
- A supervisor should require rapid remedial action if capital is not maintained or restored (Principle 4).

2.2 The modified SREP process

The modified SREP process, implemented at the beginning of 2008 and incorporating the above elements, is shown in Figure 1 below.

Figure 1

Modified SREP process



The SREP cycle (the complete process that makes up the SREP) consists of various stages (stages 1 to 6) that take place as a continuous and ongoing process, and of scheduled events.

Stage 1

The process begins with formulation by the analyst of a supervisory plan for the bank that is set out in writing. A sound, robust and well-considered supervisory plan is a necessary prerequisite to an effective SREP.

In line with the BSD's approach to risk-based supervision, the supervisory plan takes into account the key risk areas that have been identified in relation to the particular bank and their systemic relevance. In the determination of the systemic relevance and identification of the key risk areas, reliance is placed on previous years' assessments.

The supervisory plan is communicated to the bank at the start of the SREP cycle.

The main purpose of the supervisory plan is to ensure a disciplined, comprehensive and professional planning process that forms the foundation for supervisory actions, interactions and interventions.

Stage 1 is a continuous and ongoing process (ie the supervisory plan will be updated as and when new information becomes available and a change in the supervisory plan becomes warranted).

Stage 2

Throughout the SREP cycle, information is gathered by analysts and risk specialists. Examples of such sources of information are the following:

- The bank's annual report, annual financial statements and interim report
- The duly completed regulatory returns submitted to the BSD by the bank
- Correspondence between the bank and the BSD
- Graphs generated from the information submitted by the bank to the BSD, and reports prepared therefrom
- Graph discussions: discussions between the bank and the BSD in relation to the graphs generated from the information submitted by the bank to the BSD
- Prudential meetings with risk managers: meetings between the bank's risk managers and the BSD
- Prudential meetings with heads of business units: meetings between the bank's business unit heads and the BSD
- The chief executive officer meeting: meeting between the bank's CEO and the BSD
- Board meetings: meeting between the bank's board of directors and the BSD
- Meeting between the bank's board audit committee, the bank's internal audit function, the bank's external auditors and the BSD
- Financial media
- Suppliers of market data (such as McGregor BFA Net, Moneyweb, JSE SENS)
- Ratings agencies and their reports
- Investment analyst reports

Stage 2 is also a continuous and ongoing process.

Stage 3

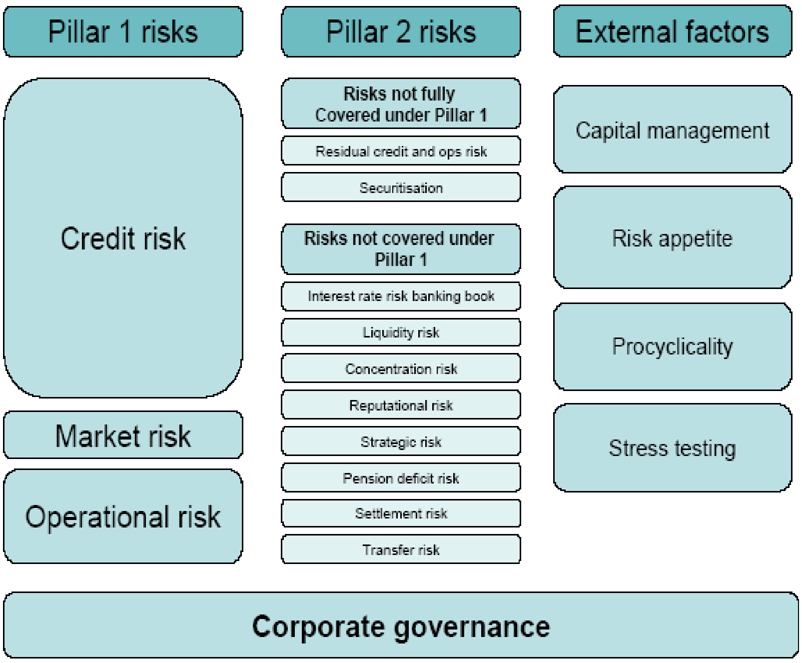
Stage 3 entails the process whereby the information gathered by analysts and risk specialists in stage 2 is assembled and then analysed and synthesised in order to form a view of the bank. The focus is on materiality and risk.

During this stage there are two distinct scheduled events that take place once during each SREP cycle.

- The first scheduled event is the submission by a bank of its ICAAP report (the ICAAP report is submitted in a non-prescriptive format by the bank to the BSD).

- The second scheduled event relates to the development of a supervisory perspective, which entails gathering information, assembling the relevant information in risk score sheets and populating the sheets, and analysing the risk review as prepared by the analyst. The score sheets cover, inter alia, Pillars 1 and 2 risks. Pillar 3 aspects should also be considered. For the purposes of developing the score sheets and analysing the information, an analytical framework has been developed. The analytical framework is depicted below.

Figure 2



It is envisaged that these two processes will enable a bank and the analyst to compare findings and challenge one another's conclusions and recommendations in a constructive manner.

Internally it is envisaged that the BSD analyst could call for a "pre-panel" review to seek guidance on priorities, clarification of issues and further work to be done. (In order to promote and improve consistency in judgements, a review panel has been established, consisting of the members of the BSD executive committee and two other senior members of management; see stage 5.)

Stage 3 consists of both continuous and ongoing processes and scheduled events.

Stage 4

Depending on the outcome of the "forming-of-a-view" stage, the analyst and the risk specialists will identify areas of the bank that may require a detailed or specialist review.

This review may be carried out by the analyst, risk specialists, an on-site review team, internal auditors, external auditors, external risk consultants, or other advisors (eg lawyers or actuaries). The resulting information gathered is incorporated into the SREP, and necessary consequential adjustments are effected.

Stage 4 is a continuous and ongoing process.

Stage 5

Stage 5 consists of the panel review process, which entails an assessment by the review panel of the procedural and substantive correctness of the SREP, the conclusions reached and the recommendations made.

The conclusions reached and recommendations generated during the "forming-of-a-view" stage (stage 3) and the focused review stage (stage 4) by the analyst (in conjunction with the relevant risk specialists, if applicable) form the basis for the panel review.

The review panel's recommendations may include remedial actions to be taken and adjustments to the individual capital requirement (ICR). (It is important to note that the ICR should not be seen as the only tool in a supervisor's armoury. Other recommendations, such as strengthening of internal controls or risk management policies and procedures, may in certain circumstances be more appropriate.)

Stage 6

Stage 6 consists of the process in which the conclusions and recommendations reached in stage 5 are fed back to the bank's board of directors, risk committee, audit committee and senior management.

Industry lessons identified are fed back into the macro-surveillance cycle and report, and may warrant ad hoc sector reviews.